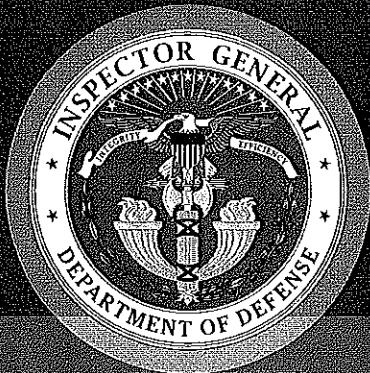


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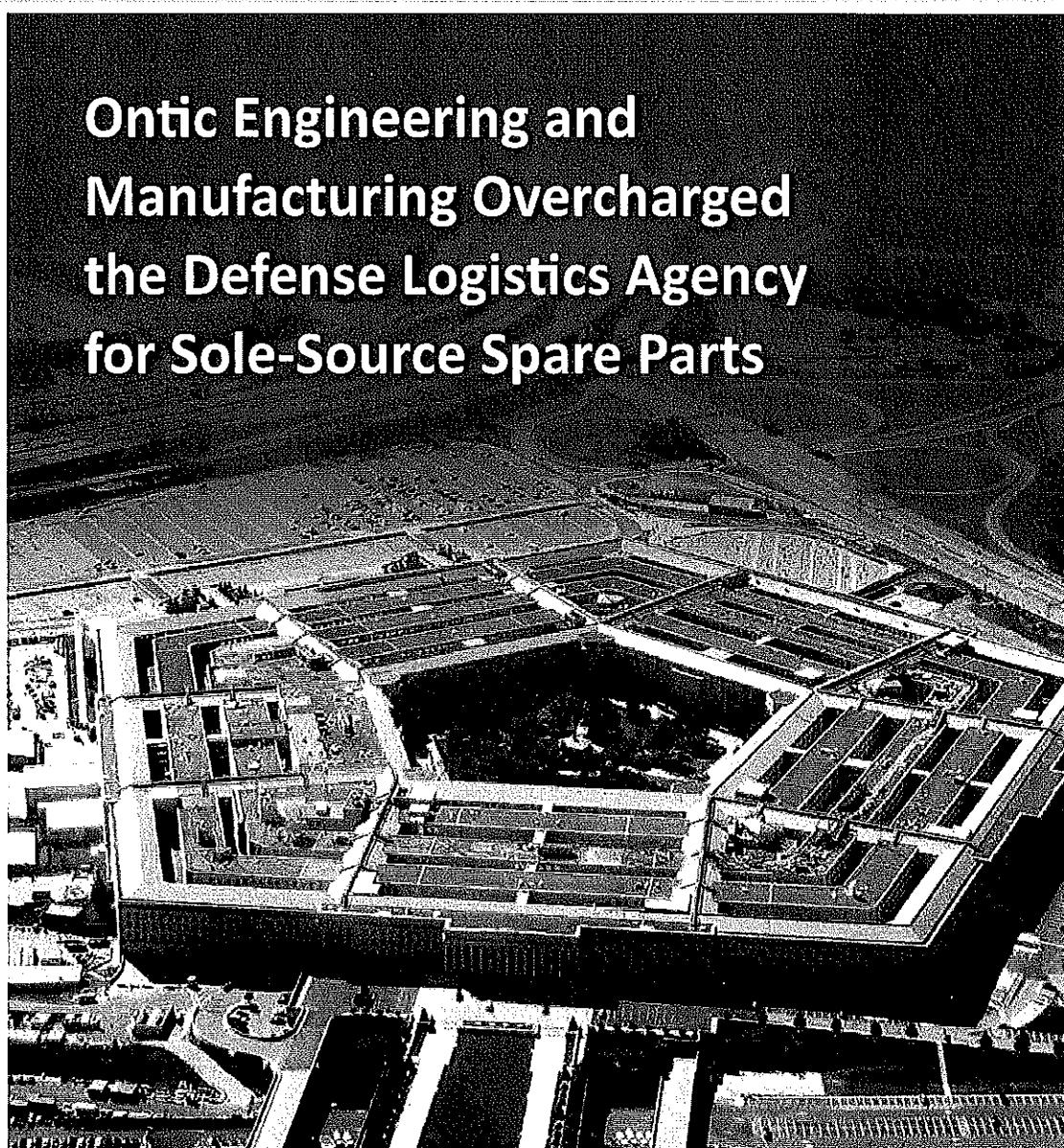
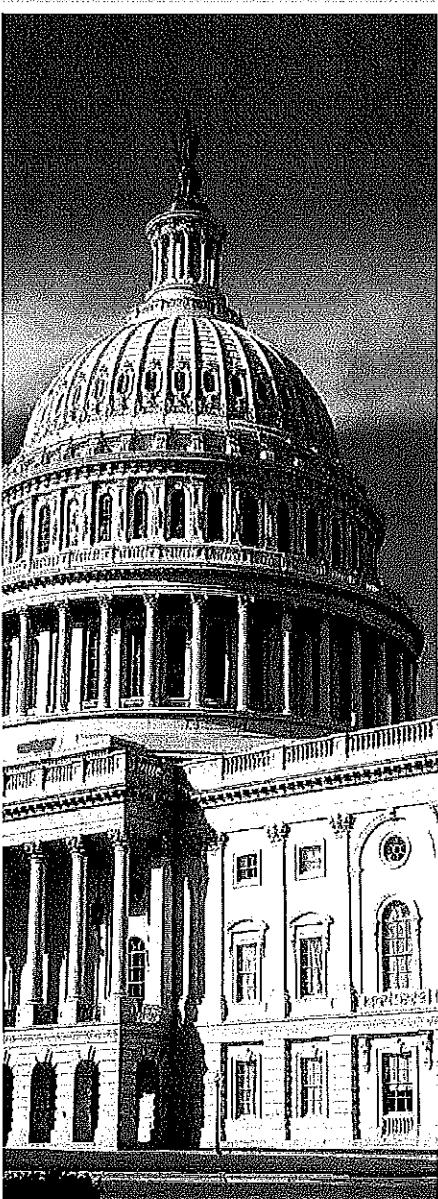


INSPECTOR GENERAL

U.S. Department of Defense

SEPTEMBER 15, 2014

Ontic Engineering and Manufacturing Overcharged the Defense Logistics Agency for Sole-Source Spare Parts



INTEGRITY ★ EFFICIENCY ★ ACCOUNTABILITY ★ EXCELLENCE

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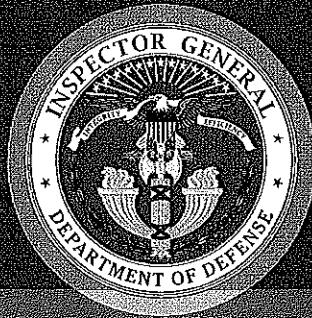
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Results in Brief

Ontic Engineering and Manufacturing Overcharged the Defense Logistics Agency for Sole-Source Spare Parts

September 15, 2014

Objective

The objective of the audit was to determine whether the Defense Logistics Agency (DLA) purchased sole-source spare parts at fair and reasonable prices from Ontic Engineering and Manufacturing (Ontic). Specifically, we nonstatistically selected for review 21 parts purchased on 21 contracts and delivery orders, valued at \$26.2 million, to determine whether DLA received fair and reasonable prices.

Findings

DLA contracting officials did not obtain fair and reasonable prices for sole-source spare parts purchased from Ontic for 21 parts, valued at \$26.2 million. DLA paid as much as 831 percent more for spare parts purchased from Ontic than it previously paid other suppliers for the same parts. Also, DLA paid Ontic approximately 124 percent more than the prices Ontic paid its suppliers to manufacture complete or nearly complete spare parts. This occurred because DLA did not conduct sufficient analysis to establish the reasonableness of Ontic's proposed prices. Specifically, DLA contracting officials used previous DoD purchase prices without determining the price reasonableness of those prices and did not eliminate unallocable and unreasonable costs included in Ontic's prices. In addition, DLA contracting officials and Ontic did not consistently comply with Federal guidance for analyzing subcontractor

Findings (cont'd)

prices to determine price reasonableness. Furthermore, licensing agreements between Ontic and the original equipment manufacturers reduced the contracting officials' leverage to negotiate fair and reasonable prices.

As a result, DLA paid approximately \$8 million more than is fair and reasonable for 21 sole-source spare parts. Additionally, based on annual procurement data, DLA will spend approximately \$11 million more than is fair and reasonable over the next 5 years if no change is made and if DLA's current level of demand for the sole-source spare parts continues.

Recommendations

We recommend that the Director, DLA, develop a quality assurance process to require contracting officers to conduct cost analysis on all Ontic proposals to determine price reasonableness, confirm contracting officers conduct and use adequate cost or price analyses, and substantiate that contracting officers verify that prime contractors conduct appropriate cost or price analyses to establish the reasonableness of proposed subcontract prices. In addition, we recommend the Director identify Ontic's purchasing system as high risk and request that the administrative contracting officer review Ontic's purchasing system, pursue other options for obtaining sole-source spare parts, recover approximately \$8 million in overpayments from Ontic, and conduct a review of all other sole-source spare parts purchased from Ontic and request refunds for overcharges.

Management Comments and Our Response

We received comments from the Director, DLA, in response to the draft of this report. The comments addressed the specifics of all the recommendations, and no further comments are required.

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Recommendations Table

Management	No Additional Comments Required
Director, Defense Logistics Agency	1.a., 1.b., 1.c., 2, 3, 4, 5

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**INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
4800 MARK CENTER DRIVE
ALEXANDRIA, VIRGINIA 22350-1500**

September 15, 2014

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE FOR ACQUISITION,
TECHNOLOGY, AND LOGISTICS
DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY
DIRECTOR, DEFENSE CONTRACT MANAGEMENT AGENCY
DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Ontic Engineering and Manufacturing Overcharged the Defense Logistics Agency for
Sole-Source Spare Parts (Report No. DODIG-2014-110)

We are providing this report for your information and use. The Defense Logistics Agency (DLA) paid approximately \$8 million more than is fair and reasonable for 21 sole-source spare parts. Additionally, DLA will spend approximately \$11 million more than is fair and reasonable over the next 5 years if DLA takes no action.

We considered management comments on a draft of this report when we prepared the final report. Comments from the Defense Logistics Agency addressed the specifics of all the recommendations and conformed to the requirements of DoD Directive 7650.3; therefore, we do not require additional comments.

We appreciate the courtesies extended to the staff. Please direct questions to me at
(703) 604 [redacted]^{(b)(6)}

Jacqueline L. Wicecarver
Jacqueline L. Wicecarver
Assistant Inspector General
Acquisition, Parts, and Inventory

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DODIG-2014-110 | iii

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Introduction

Objective

The overall objective of the audit was to determine whether the Defense Logistics Agency (DLA) was purchasing sole-source spare parts at fair and reasonable prices from Ontic Engineering and Manufacturing (Ontic). See the Appendix for a discussion of the scope and methodology and prior audit coverage related to the objective.

Background

According to DLA,¹ it is DoD's largest combat-support agency, responsible for supplying over 84 percent of the Military Services' spare parts. DLA has six primary-level field activities, including DLA Aviation. Headquartered in Richmond, Virginia, DLA Aviation is the U.S. military's integrated materiel manager for more than 1.1 million repair parts and operating supply items in support of all fixed- and rotor-wing aircraft, including spare parts for engines on fighters, bombers, transports, and helicopters; all airframe and landing-gear parts; flight-safety equipment; and propeller systems.

Ontic Engineering and Manufacturing

Ontic, located in Chatsworth, California, is a wholly owned subsidiary of BBA Aviation, a public limited company in London, United Kingdom. According to its management, Ontic specializes in supplying and supporting legacy parts² by acquiring the data rights or establishing licensing agreements with the original equipment manufacturer (OEM). Ontic provides more than 4,000 parts and assemblies used on a variety of commercial and military aircraft. Its licensed products include engine components and accessories, hydraulics, electronics, avionics, fuel controls, motors and pumps, heat exchangers, and landing gear. According to the Defense Contract Audit Agency (DCAA), (b)(4) DLA's obligations to Ontic from FY 2008 through FY 2013 totalled about \$120.2 million.

Ontic's Business Model

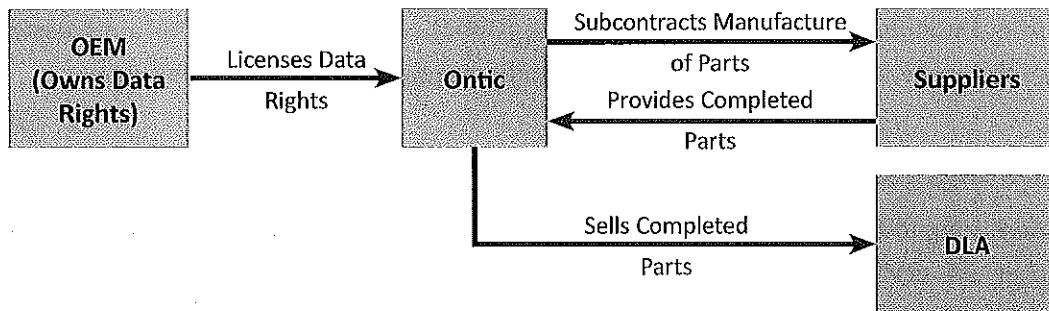
According to Ontic, their business model is to support legacy parts through licensing agreements with the OEMs, rather than develop new products. Ontic subcontracts with various suppliers to provide parts to DoD. Ontic responds to and fills DoD requirements

¹ We obtained this information from www.dla.mil/pages/about_dla.aspx, www.dla.mil/pages/ataglance.aspx, and www.aviation.dla.mil.

² According to Ontic, legacy parts are older parts with a diminishing demand that the OEM no longer desires to produce or support.

by quoting, procuring, and receiving parts from its suppliers; inspecting parts after the suppliers manufacture them; and at times, conducting limited assembly and testing. Figure 1 shows Ontic's procurement process.

Figure 1. Ontic's Procurement Process



Nonstatistical Audit Sample of Spare Parts

We reviewed 21 sole-source spare parts valued at \$26.2 million. Our nonstatistical sample included seven parts purchased on seven contracts and eight parts purchased on eight delivery orders placed against a basic ordering agreement. We also included 6 parts purchased on 6 additional contracts from a list of 20 parts that DLA cost and pricing officials identified as potentially overpriced. See the Appendix for more detailed information on the nonstatistical sample selection.

Review of Internal Controls

DoD Instruction 5010.40, "Managers' Internal Control Program (MICP) Procedures," May 30, 2013, requires DoD organizations to implement a comprehensive system of internal controls that provides reasonable assurance that programs are operating as intended and to evaluate the effectiveness of the controls. We identified internal control weaknesses associated with DLA purchases of sole-source parts from Ontic. DLA contracting officials did not conduct sufficient analysis to establish the reasonableness of Ontic's proposed prices. Specifically, DLA contracting officials used previous DoD purchase prices without determining the price reasonableness of the historical prices and did not eliminate unallocable and unreasonable costs included in Ontic's prices. In addition, DLA contracting officials and Ontic did not consistently comply with Federal guidance for analyzing subcontractor prices to determine price reasonableness. We will provide a copy of the report to the senior officials responsible for internal controls in the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics; DLA; DCAA; and Defense Contract Management Agency (DCMA).

Finding

Ontic Was Overpaid for Sole-Source Spare Parts

DLA contracting officials did not obtain fair and reasonable prices for sole-source spare parts purchased from Ontic for 21 parts³ valued at \$26.2 million. Specifically, DLA:

- paid as much as 831 percent more for spare parts purchased from Ontic than it previously paid to other suppliers for the same part; and
- paid Ontic approximately 124 percent more than the prices Ontic paid its suppliers to manufacture 18 of 21 complete or nearly complete sole-source spare parts.⁴

This occurred because DLA did not conduct sufficient analysis to establish the reasonableness of Ontic's proposed prices. Specifically,

- DLA contracting officials used previous DoD purchase prices without determining the price reasonableness of the historical prices for three parts;
- DLA contracting officials did not eliminate unallocable and unreasonable costs included in Ontic's prices; and
- DLA contracting officials and Ontic did not consistently comply with Federal guidance for analyzing subcontractor prices to determine price reasonableness.

In addition, the licensing agreements between Ontic and the OEMs reduced the contracting officials' leverage to negotiate fair and reasonable prices. As a result, DLA paid approximately \$8 million more than is fair and reasonable for 21 sole-source spare parts, valued at \$26.2 million. DLA will spend approximately \$11 million more than is fair and reasonable for 21 spare parts over the next 5 years if no change is made and DLA's current demand for sole-source spare parts continues.

³ We reviewed 13 contracts and 8 delivery orders placed against one basic ordering agreement.

⁴ Ontic did not provide the data necessary to accurately calculate the supplier's price to Ontic for 3 of 21 parts.

Fair and Reasonable Prices Not Obtained

~~(FOUO)~~ DLA contracting officials did not obtain fair and reasonable prices for sole-source spare parts purchased from Ontic.⁵ Specifically, DLA paid as much as 831 percent more for spare parts purchased from Ontic than what DLA previously paid other suppliers for the same parts. For example, in February 2011, DLA purchased 22 matrix assemblies from Ontic for ^{(b)(4)} per unit. In August 1998,⁶ DLA purchased the same part from the OEM for ^{(b)(4)} per unit. Adjusting the 1998 unit price with an annual escalation factor,⁷ DLA paid ^{(b)(4)} more per part, or 831 percent higher than the previous purchase price. Similarly, in December 2012, DLA purchased 91 housing and insulation units from Ontic for ^{(b)(4)} per unit. In January 2006, DLA paid the OEM ^{(b)(4)} per unit for the same part. After adjusting the 2006 unit price with an annual escalation factor, DLA paid Ontic ^{(b)(4)} more per part, or a ^{(b)(4)} percent increase in unit price. Table 1 compares the unit prices DLA paid Ontic with prices DLA previously paid other suppliers for the same parts for 20 of 21 parts we reviewed.⁸

~~(FOUO)~~
DLA paid
as much as 831
percent more for spare
parts purchased from
Ontic than what DLA
previously paid other
suppliers for the
same parts.

⁵ Fourteen DLA contracting officials were responsible for awarding 21 contracts and delivery orders we reviewed.

⁶ We selected the August 1998 contract for review because the more recent contracts were also awarded to Ontic or we could not verify the contract price. Because our objective was to determine whether Ontic's prices were fair and reasonable, we compared prices to contractors other than Ontic.

⁷ To inflate the August 1998 unit price of ^{(b)(4)} to the February 2011 unit price, we used Producer Price Index WPU1425—Other Aircraft Parts and Equipment from the Bureau of Labor Statistics, the principal Federal agency for measuring labor market activity, working conditions, and price changes. The agency's Producer Price Index program measures changes in average selling prices of commercial products, including aircraft parts and equipment.

⁸ The Electronic Document Access database did not contain the previous contracts for one part, the Linear Electro-Mechanical Actuator, and DLA did not have a procurement history for the part to verify the purchase price. We did not include the Linear Electro-Mechanical Actuator in Table 1.

(FOUO) Table 1. Ontic's Prices Compared With Previous Purchase Prices

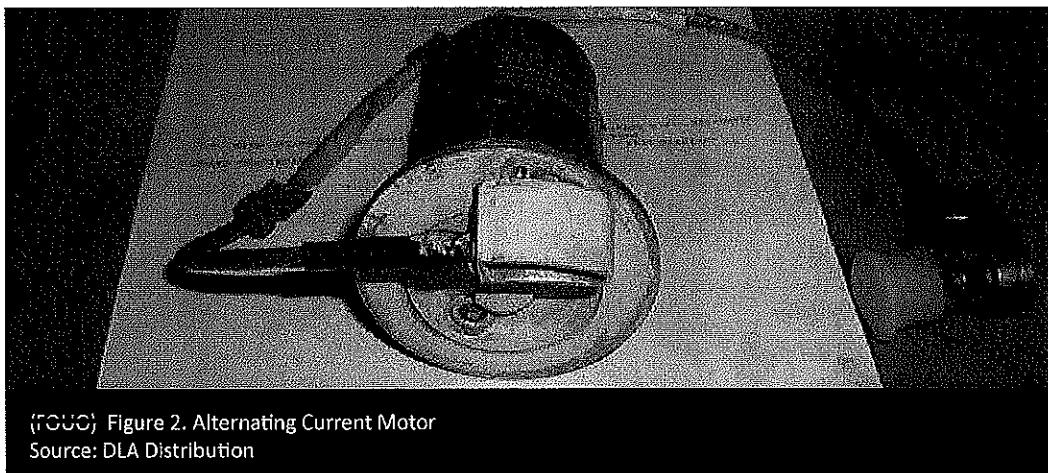
Part Description	Previous Unit Price (escalated)	Ontic's Contract Unit Price to DLA ¹	Difference (dollars)	Difference (percent) ²
Matrix Assembly	(b) (4)	(b) (4)	(b) (4)	(b) (4)
Alternating Current Motor				
Fluid Filter Cover				
Housing and Insulation				
Multiplying Lever and Bracket				
Refrigeration Heat Interchanger				
Air Heat Exchanger				
Control Cam				
Forward Housing and Inserts Assembly				
Linear Actuating Cylinder Assembly				
Axle Socket Assembly				
Strut Piston Assembly				
Outer Cylinder Assembly				
Outer Cylinder Assembly				
Strut Cylinder Assembly				
Drive Tube				
Actuating Cylinder				
Strut Assembly Cylinder				
Strut Cylinder Assembly				
Direct Current Motor ³				
(FOUO) Total Markup	\$504,828.64	\$812,811.65	\$307,983.01	61.0

¹ For 20 of the 21 parts, Ontic's contract unit prices to DLA included royalty fees. Ontic's contract unit price to DLA for the Refrigeration Heat Interchanger part did not include royalty fees.

² Minor inconsistencies in the percent differences may occur due to rounding.

³ According to IHS Haystack Gold, Ontic was the only previous supplier for this part. Therefore, Ontic was the contractor for the previous purchase price we reviewed for this part.

(FOUO) In addition, DLA paid Ontic approximately 124 percent more than the price Ontic paid its suppliers for the parts. For 18 of 21 parts reviewed, Ontic purchased complete or nearly complete parts from its suppliers to meet contract requirements. For example, in 2011, Ontic sold two alternating current motors to DLA for (b) (4) per unit; Ontic purchased the complete motors from its supplier for just (b) (4) per unit. Therefore, Ontic sold those motors to DLA at a (b) (4) percent increase. Figure 2 shows the alternating current motor.



(FOUO) Likewise, in 2010, DLA purchased 10 air heat exchangers from Ontic for (b) (4) per unit. However, Ontic purchased the air heat exchangers as a complete unit from its supplier for (b) (4) per unit, resulting in a (b) (4) percent increase per unit. Table 2 shows Ontic's price increases to DLA over what it paid its suppliers for 18 of 21 spare parts.⁹ Figure 3 shows the air heat exchanger.

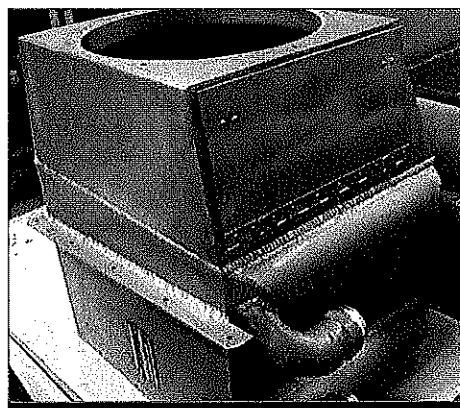


Figure 3. Air Heat Exchanger
Source: www.wbparts.com

⁹ Ontic did not provide the data necessary to accurately calculate the suppliers' prices for 3 of 21 parts.

~~(FOUO) Table 2. Ontic's Increases Over Supplier's Prices~~

Part Description	Supplier's Unit Price to Ontic	Ontic's Contract Unit Price to DLA	Difference (dollars)	Difference (percent)*
Fluid Filter Cover	(b) (4)	(b) (4)	(b) (4)	(b) (4)
Alternating Current Motor				
Air Heat Exchanger				
Multiplying Lever and Bracket				
Control Cam				
Strut Assembly Cylinder				
Outer Cylinder Assembly				
Linear Actuating Cylinder Assembly				
Matrix Assembly				
Strut Piston Assembly				
Actuating Cylinder				
Forward Housing and Inserts Assembly				
Housing and Insulation				
Strut Cylinder Assembly				
Outer Cylinder Assembly				
Strut Cylinder Assembly				
Refrigeration Heat Interchanger				
Axle Socket Assembly				
(FOUO) Total Markup	\$355,138.77	\$797,972.46	\$442,833.69	124.7

* Minor inconsistencies in the percent differences may occur due to rounding.

Historical Price Analyses Not Sufficient

For three parts, DLA did not conduct sufficient analysis to establish the reasonableness of Ontic's proposed prices. Specifically, DLA contracting officials used previous DoD purchase prices (historical prices) without determining the price reasonableness of those historical prices. Federal Acquisition Regulation (FAR) Subpart 15.404-1, "Proposal Analysis Techniques," requires the contracting officer to determine that prices are fair and reasonable. Price analysis is the process of examining and evaluating a proposed price without evaluating the separate cost elements and proposed profit. This type of analysis is used to review proposals where certified

cost or pricing data is not required. Although historical price analysis is a valid technique for determining fair and reasonable prices, the FAR states that the prior price must be a valid basis for comparison. The FAR provided the contracting officer "if" and "then" statements for making accurate decisions. Specifically,

- if significant time has passed between the last and current purchase,
- if the terms and conditions of the acquisition are significantly different, or
- if the reasonableness of the prior price is uncertain,
- then the prior price may not be a valid basis for comparison.

The Defense Federal Acquisition Regulation Supplement (DFARS) Procedures, Guidance, and Information (PGI) Subpart 215.403-3(4), "Reliance on prior prices paid by the Government," further requires the contracting officer to verify and document that sufficient analysis was performed to determine that the prior price was fair and reasonable when relying on prior prices paid by the Government.

~~(FOUO)~~ DLA contracting officials compared proposed prices with previous purchase prices to determine the reasonableness of Ontic's prices for 3 of 21 spare parts reviewed.¹⁰ For the 3 parts, this historical price analysis was not an effective means of determining reasonableness because the previous price was not verified or the price used for comparison purposes was not valid. For example, in October 2011, DLA used historical price analysis to determine that Ontic's proposed price for 55 control cams priced at ^{(b) (4)} per unit¹¹ was fair and reasonable. DLA contracting officials compared Ontic's proposed prices with previous prices paid on two contracts: one was another Ontic contract that DLA awarded in January 2011 for 23 control cams priced at ^{(b) (4)} per unit, and one contract that DLA awarded to ^{(b) (4)} ^{(b) (4)} in August 2001 for 30 control cams priced at ^{(b) (4)} per unit. DLA determined that Ontic's price was consistent with previous pricing and, therefore, fair and reasonable. However, the contract file did not include documentation that the contracting officer verified that the previous prices paid were fair and reasonable. Furthermore, DLA's use of prices from a contract awarded 10 years before the contract award, when more recent contracts were available for comparison, made the comparison invalid. DLA did not verify that its historical price analysis results were accurate and reliable for evaluating Ontic's proposed prices without first ensuring the reasonableness of previous prices and the validity of the comparison.

¹⁰ DLA conducted other methods of price analysis or cost analysis for 18 of 21 parts.

¹¹ Ontic's October 2011 proposal for 55 control cams priced at ^{(b) (4)} per unit updated its May 2011 proposal for 55 control cams priced at ^{(b) (4)}.

(FOUO) In another example, Ontic sold two alternating current motors to DLA in October 2011 for (b)(4) per unit.¹² The DLA contracting official compared Ontic's proposed price of (b)(4) to previous prices paid on two contracts to determine whether Ontic's price was fair and reasonable.

- (FOUO) DLA compared Ontic's price to a contract awarded to (b)(4) in July 2011 for one surplus part, which remained from a previous contract, priced at (b)(4). Ontic's proposed price was (b)(4) percent more than (b)(4) contract price; therefore, DLA should have concluded Ontic's proposed price was not fair and reasonable.
- (FOUO) Instead of concluding that Ontic's proposed price was not fair and reasonable, DLA compared Ontic's price to another contract. DLA compared Ontic's proposed price to a contract awarded to (b)(4) in October 1984 for one part priced at (b)(4). According to the contracting official, she used the October 1984 contract to determine price reasonableness because the price was in line with Ontic's proposal and could be used to justify Ontic's price.
- (FOUO) DLA should have used the most recent contract after the July 2011 award to (b)(4) to determine whether the price for the part was fair and reasonable. Specifically, DLA should have used a contract awarded to (b)(4) in May 2006 for the sale of 16 alternating current motors for (b)(4) per unit. Had the contracting official compared Ontic's proposed price with (b)(4) price, she should have determined that the maximum price, after accounting for annual escalation, should be (b)(4) per unit. As a result, Ontic's proposed price was (b)(4) or (b)(4) percent more than the previous price paid and was not fair and reasonable.

DLA should develop a quality assurance process to confirm that DLA contracting officers are conducting thorough price analysis, in accordance with FAR Subpart 15.404-1. The contracting officer needs to document that adequate price analysis was performed to determine that previous prices were fair and reasonable.

¹² On November 22, 2011, DLA modified the contract to change the unit price from (b)(4) to (b)(4).

(FOUO) DLA's historical price analysis for fluid filter covers and alternating current motors was not sufficient to identify Ontic's overcharges of royalty fees. Ontic's selling price to DLA for fluid filter covers in September 2011 and alternating current motors in October 2011 included (b) (4) percent royalty fees. However, Ontic's licensing agreement with (b) (4) which granted Ontic the rights to sell these parts, only permitted Ontic a (b) (4) percent royalty on Government sales.

(FOUO)
Ontic
overcharged DLA
\$^{(b) (4)} in royalty
fees for fluid filter
covers and \$^{(b) (4)}
for alternating
current motors.

Therefore, Ontic overcharged DLA (b) (4) in royalty fees for fluid filter covers and (b) (4) for alternating current motors. DLA conducted historical price analysis;¹³ however, it was not effective because it did not require an evaluation of separate cost elements, such as royalty fees. The contracts for these parts were under the Truth in Negotiation Act threshold;¹⁴ therefore, DLA was not required to conduct cost analysis, the review and evaluation of individual cost elements in a contractor's proposal to determine a fair and reasonable price. However, because there were indications that Ontic overpriced its royalty costs on proposals, DLA should conduct additional analysis to ensure that Ontic's prices are fair and reasonable. DLA should develop a quality assurance process requiring that DLA contracting officers conduct cost analysis on all Ontic proposals, in addition to price analysis, to determine the reasonableness of Ontic's prices, in accordance with FAR 15.404-1, which states that if a fair and reasonable price cannot be determined through price analysis alone, cost analysis may be used to determine reasonableness.

DLA Did Not Eliminate Ontic's Unallocable and Unreasonable Costs

DLA contracting officials did not eliminate unallocable and unreasonable costs included in Ontic's prices. According to FAR Subpart 31.2, "Contracts with Commercial Organizations," a cost is allowable to the Government when it is 1) allocable, 2) reasonable, 3) complies with applicable Cost Accounting Standards, or generally accepted accounting practices, 4) complies with the terms of the contract, and 5) complies with the limitations set by FAR Subpart 31.2. We identified costs included in Ontic's cost estimates that did not comply with the first two requirements for determining allowability.

¹³ DLA's contract file for fluid filter covers indicated that they also conducted cost analysis; however, the contract file did not contain adequate documentation to substantiate that DLA conducted cost analysis. Therefore, we could not verify that it occurred.

¹⁴ The Truth in Negotiations Act threshold for contracts awarded on or after October 1, 2010, is \$700,000.00.

Unallocable Costs Were Not Identified and Eliminated From Prices

~~(FOUO)~~ DLA contracting officials did not eliminate unallocable costs from Ontic's prices. FAR Subpart 31.2 states that a cost is allocable to a Government contract if the cost was incurred specifically for the contract, benefits the contract and other work when the cost can be reasonably distributed based on the benefit received, or is necessary to the overall operation of the business even though a direct relationship between the cost and the Government contract cannot be shown. Ontic's General and Administrative (G&A) costs were not allocable to Ontic's subcontracted material costs. In addition, Ontic included unallocable stocking costs in its material overhead, which were unallowable.

Subcontractor Costs for Purchased Parts Were Considered Direct Materials

~~(FOUO)~~ Ontic predominately purchased complete or nearly complete parts from subcontractors for delivery on the DoD contracts we reviewed. Ontic's material costs represented the work of its subcontractors and not the purchase of direct materials for Ontic's use in manufacturing the parts. Ontic was unable to substantiate its claims of subcontractor management or value added to the work of its subcontractors to justify the allocation of G&A costs to its subcontracted material costs. Therefore, DLA should disallow G&A costs on material, which ranged from ~~(b)(4)~~ percent, depending on the contract year ranging from 2007 to 2012, because Ontic's G&A was unallocable to Ontic's material costs.

Ontic Charged DoD for Stocking Costs

~~(FOUO)~~ Ontic included stocking costs in its material overhead rate. ~~(b)(4)~~

~~(b)(4)~~

~~(b)(4)~~ Therefore, DLA should disallow Ontic's stocking costs, effectively reducing Ontic's allowable material overhead rates by between ~~(b)(4)~~ percent, depending on contract year,¹⁵ because Ontic's stocking costs were unallocable.

¹⁵ Ontic's material overhead rates included ~~(b)(4)~~. The range of material overhead rates applies to contract years 2009 through 2012. Ontic's actual costs for 2008 did not identify stocking costs; therefore, we did not include 2008 in the material overhead rate calculation.

Ontic's Prices Included Unreasonable Costs

Ontic included in its prices, unreasonable costs associated with G&A, profit, and royalty fees. According to FAR Subpart 31.2, a cost is reasonable if, in its nature and amount, it does not exceed what a prudent person conducting competitive business would incur. DLA contracting officials did not eliminate unreasonable costs from Ontic's prices.

Excessive Profit Charged

(FOUO) Ontic applied profit on costs before royalty fees as high as (b)(4) percent. According to FAR Subpart 15.404-4, "Profit," agencies making noncompetitive contract awards over \$100,000 totaling \$50 million or more a year must use a structured approach for determining profit or fee objectives when cost analysis is required. Furthermore, DFARS Subpart 215.404-4, "Profit," states that DoD's structured approach for profit analysis is the weighted-guideline method, which calculates profit based on factors such as performance risk, contract-type risk, and cost efficiency. We obtained and reviewed the contracting officer's weighted-guideline profit analyses when they were available, they recommended profit rates between 9 and 19 percent. Based on these guidelines, the profit rates Ontic charged for 19 of 21 contracts were unreasonable and excessive. We selected a profit rate of 15 percent, which fell within the recommended profit rates,¹⁶ as more reasonable and still providing incentive to Ontic.

Ontic Charged Royalty on Royalty

(FOUO) Ontic increased the final price to DoD through the duplication of royalty fees. Ontic's royalty fee calculations were unreasonable because Ontic based them on a percentage of the total unit price (which already included royalty fee), thereby collecting a royalty fee on its royalty fee. In addition, for 14 of 21 parts, Ontic charged G&A and/or profit on those royalty fees. Although royalty fees are an acceptable part of doing business, the collection and payment of royalty fees to the licensor required minimal effort from Ontic and did not justify charging G&A and profit on the royalty fees.

(FOUO) Table 3, "Air Heat Exchanger Pricing," provides an illustration of Ontic's unreasonable pricing practices. Ontic applied a (b)(4) percent profit rate to each part. In addition, Ontic duplicated a portion of its royalty fee when it charged a (b)(4) percent royalty fee on its (b)(4) unit price. Ontic's unit price included the royalty; therefore, by charging royalty as percentage of unit price, Ontic charged royalty on its royalty.

¹⁶ The median profit rate in the weighted-guideline profit analyses was 15 percent.

(FOUO) In addition, Table 3 shows that Ontic charged (b)(4) in G&A and (b)(4) in profit on the royalty for each air heat exchanger, even though Ontic already applied G&A and profit to costs before charging the royalty.

(FOUO) *Table 3. Air Heat Exchanger Pricing*

Cost Element	Cost per Part
Labor (b)(4)	(b)(4)
Materials (b)(4)	
Other Direct Materials	
Material Overhead (b)(4)	
G&A (b)(4)	
Subtotal (b)(4)	
Profit (b)(4)	
Total Before Royalties	
Royalty (b)(4)*	
G&A on Royalty (b)(4)	
Profit on Royalty (Ontic calculation based on (b)(4))	
Total Royalty	
(FOUO) Unit Price (Total Before Royalties + Total Royalty)	

* Ontic performed a series of mathematical calculations to determine its royalty cost.

DLA should develop a quality assurance process requiring that DLA contracting officers conduct adequate cost and price analysis, as required, to verify that contractor prices are fair and reasonable, as required by FAR Subpart 15.404-1.

Subcontractor Prices Were Not Analyzed

DLA and Ontic did not consistently comply with Federal guidance for analyzing subcontractor price proposals. Specifically, FAR Subpart 15.404-3, "Subcontractor Pricing Considerations," requires contracting officers to determine price reasonableness for prime contracts, including subcontracting costs. The FAR further states that the prime contractor or subcontractor shall conduct appropriate cost or price analyses to establish the reasonableness of proposed subcontract prices. In addition, the contracting officer should take into account whether the contractor has an approved purchasing system.

Reasonableness of Subcontractor Costs Was Not Established

(FOUO) DLA contracting officials and Ontic did not consistently evaluate subcontractor prices to establish price reasonableness. Subcontractor prices accounted for §(b)(4) of §(b)(4) in contracts reviewed; however, DLA only analyzed §(b)(4) of the §(b)(4) in subcontractor prices for three contracts, and

Ontic did not analyze any subcontractor prices. The lack of analysis of subcontractor proposals increased the risk that Ontic and, later, DoD paid prices that were not fair and reasonable. For example, one subcontractor sold 55 control cams to Ontic for §(b)(4) per unit. Ontic then sold the control cams to DLA for §(b)(4) per unit. According to the subcontractor's cost breakdown, profit was §(b)(4), §(b)(4) percent of cost. However, the subcontractor's profit was actually §(b)(4) percent of its price, and represented approximately §(b)(4) percent of the costs. The §(b)(4) percent of cost was calculated by dividing the subcontractor's profit of §(b)(4) by its cost of §(b)(4). Had DLA or Ontic conducted a review of the subcontractor's cost breakdown, it would have found that profit was §(b)(4) percent of its price, or §(b)(4) percent of its cost. Ontic was not required to conduct cost analysis because the purchase was under the Truth in Negotiation Act threshold. However, if Ontic had analyzed its subcontractor's prices, it could have identified the excessive profit, and DLA or Ontic could have negotiated a more reasonable profit rate.

(FOUO) In another example, a subcontractor sold 18 multiplying levers and brackets to Ontic for §(b)(4) per unit, which Ontic sold to DLA for §(b)(4) per unit. According to the subcontractor's cost breakdown, it applied a §(b)(4) percent profit rate; however, the subcontractor actually used a §(b)(4) percent profit rate. The §(b)(4) percent profit rate was calculated by dividing the subcontractor's profit of §(b)(4) by its cost before profit of §(b)(4). Again, Ontic was not required to conduct cost analysis because the purchase was under the Truth in Negotiation Act threshold. However, if Ontic performed a cost analysis on subcontractor prices, it could have identified the excessive profit that led to a cost of §(b)(4) per unit instead of §(b)(4) per unit, and potentially negotiated a better price that could have been passed as savings to DLA. As a result, Ontic overcharged DLA §(b)(4) more for

¹⁷ Ontic did not provide the data necessary to accurately calculate the subcontractor's costs for §(b)(4) of the \$26.2 million reviewed.

~~(FOUO)~~ materials than needed. DLA should develop a process to ensure prime contractors conduct appropriate cost or price analyses to establish the reasonableness of proposed subcontract prices and include the results of these analyses in its price proposals.

Review of Purchasing System Could Benefit DoD

According to FAR Subpart 15.404-3, when analyzing subcontractor costs as part of a fair and reasonable price determination, the contracting officer should consider whether the contractor has an approved purchasing system. The administrative contracting officer can conduct a Contractor's Purchasing System Review (CPSR) to evaluate the efficiency and effectiveness with which the contractor spends Government funds and complies with Government policy when subcontracting. A CPSR evaluates whether the contractor obtained competition and performed adequate cost and pricing analysis, along with a number of other factors necessary to ensure that proposed subcontracts are consistent with current policy and sound business judgment. Additionally, a CPSR requires the administrative contracting officer to maintain a sufficient level of surveillance to ensure that the contractor is effectively managing its purchasing program.

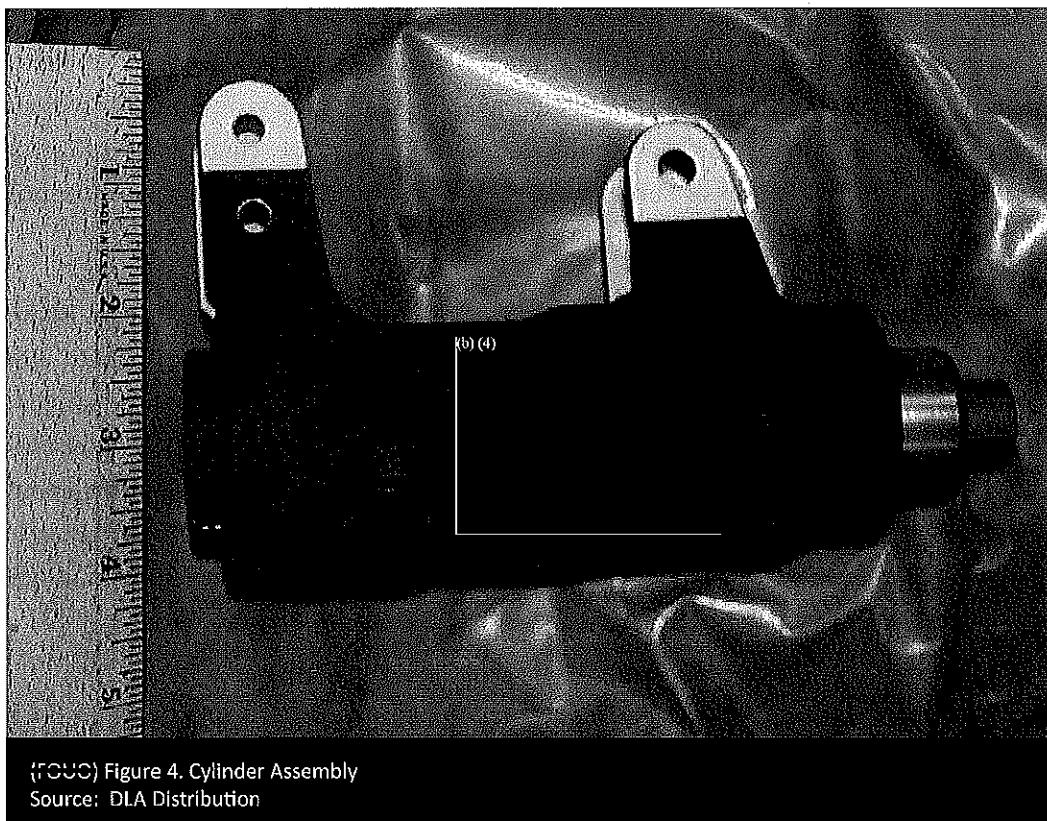
Although there is no FAR requirement for a CPSR of Ontic, the overcharges shown in this report warrant a CPSR and subsequent surveillance that would benefit DoD. The review and continuing surveillance would ensure Ontic is performing adequate cost and price analysis of its subcontractors' proposals to reduce the DoD's and Ontic's risk of paying subcontractor prices that are not fair and reasonable. DLA should identify Ontic's purchasing system as high risk and request that the administrative contracting officer perform a purchasing system review to determine Ontic's efficiency and effectiveness in spending DoD funds.

Licensing Agreements Restricted Negotiations and Increased Costs

Ontic's licensing agreements with the OEMs restricted competition, increased costs, and did not provide DLA contracting officials the leverage they needed to negotiate fair and reasonable prices. Specifically, Ontic obtained data rights to manufacture and distribute spare parts through the use of licensing agreements with the OEMs. Ontic sought to obtain licensing agreements for legacy parts, which essentially made Ontic the sole-source supplier for these parts. Ontic paid the OEMs an up-front, one-time fee for the licensing agreements, which Ontic recouped through G&A rates applied to Government contracts.

Impact of Licensing Agreements on Negotiations

(FOUO) To illustrate the impact licensing agreements had on negotiations, consider DLA's efforts to purchase cylinder assemblies for the AH-64A Apache helicopter. In 2007, Ontic obtained an exclusive licensing agreement with (b)(4), the OEM, for cylinder assemblies and other landing gear. As a result, Ontic became the only authorized supplier in North America for the cylinder assemblies used on the AH-64A Apache helicopters. In February 2012, after 4 months of attempting to negotiate a fair and reasonable price with Ontic, DLA was compelled to agree to a price of (b)(4) per unit, to prevent the grounding of the AH-64A Apache helicopters. The negotiated (b)(4) unit price was approximately (b)(4) percent over DLA's (b)(4) target price. Figure 4 shows a picture of the cylinder assembly.



(FOUO) Figure 4. Cylinder Assembly
Source: DLA Distribution

~~(FOUO)~~ In another example, DLA purchased housing and insulation from Ontic. In 2003, Ontic obtained a licensing agreement with ~~(b)(4)~~ for two hydromechanical engine controls and their components, which included the housing and insulation, making Ontic the sole supplier for these parts. Ontic initially proposed a price of ~~(b)(4)~~ per unit, which significantly exceeded the Government's target price of ~~(b)(4)~~ per unit. Negotiations spanned 14 months and eventually were elevated to the DLA Division Chief and Ontic's Director of Contracts, because Ontic failed to provide requested cost and pricing data in a timely manner to support its proposed price. After negotiations were elevated and the procurement quantity was increased, Ontic revised its quote to ~~(b)(4)~~ per unit, which DLA accepted. However, DLA determined the price was not fair and reasonable but was the best attainable price and that further delays in awarding the contract jeopardized the readiness level of the CH-53 Sea Stallion helicopter. Ontic's licensing agreement, combined with a critical supply need, restricted DLA's leverage to negotiate and compelled DLA to accept Ontic's prices.

Licensing Agreements Increased Costs to DoD

~~(FOUO)~~ Ontic entered into these licensing agreements with the OEMs for minimal cost and, due to the sole-source environment the licensing agreements created, Ontic quickly recovered its initial investment. For example, Ontic obtained a licensing agreement, which included air heat exchangers, from ~~(b)(4)~~ for a one-time, up-front payment of ~~\$~~¹⁸ ~~(b)(4)~~ plus an additional ~~(b)(4)~~ percent royalty on Ontic's selling price each time the air heat exchanger was sold. For the contract reviewed, Ontic sold 10 air heat exchangers to DLA with a profit of ~~\$~~¹⁸ ~~(b)(4)~~ per unit, or a total profit of ~~\$~~¹⁸ ~~(b)(4)~~. Ontic's profit from this one contract was four times more than Ontic's initial up-front payment. Similarly, for the licensing agreements that included the AH-64A Apache and CH-53 Sea Stallion parts discussed previously, Ontic made initial payments to the OEMs for ~~\$~~¹⁸ ~~(b)(4)~~ respectively. In addition, both licensing agreements included a ~~(b)(4)~~ percent royalty on Ontic's selling price each time the parts were sold. Ontic's licensing agreement for cylinder assemblies used on the AH-64A Apache helicopters also applied to eight other contracts we reviewed.

¹⁸ ~~(FOUO)~~ The license agreement is for ~~(b)(4)~~

~~(FOUO)~~ Ontic's profit on these 9 contracts alone was \$^{(b)(4)} which was ^{(b)(4)} percent greater than Ontic's initial \$^{(b)(4)} payment. In addition, Ontic's total profit of \$^{(b)(4)} on one contract for the CH-53 Sea Stallion parts was over 7 times more than Ontic's initial payment.

~~(FOUO)~~ We further determined that Ontic recovered its up-front licensing costs by distributing these costs to its G&A expense rate, which is then applied to direct and indirect labor, material, and royalty fees on contracts. Ontic's royalty fees were only incurred when Ontic sold a part, which Ontic charged as a direct cost on the contract. Furthermore, we determined the Government was paying Ontic profit on its licensing costs because Ontic charged profit on its G&A and royalty fees. To alleviate the restriction that Ontic's licensing agreements created, DLA should pursue other options for obtaining spare parts. DLA should consider whether they can obtain data rights sufficient for competition from original equipment manufacturers, negotiate concessions on Ontic's ongoing royalty fees, or establish an option for the direct payment of royalty fees by the Government to the OEMs. Additionally, DLA should develop a strategy to reverse-engineer the parts or develop Government-owned technical data packages, so DLA can qualify new sources and create a competitive market.

Overpayment for Sole-Source Spare Parts

~~(FOUO)~~ DLA paid approximately \$8 million more than is fair and reasonable for 21 sole-source spare parts that cost \$26.2 million. Table 4 compares the prices DLA accepted to OIG calculations.

~~(FOUO) Table 4. Comparison of Calculated Prices~~

Description	DLA Contract Price	OIG Calculated Price*	Difference (dollars)
Outer Cylinder Assembly	(b) (4)		
Direct Current Motor			
Strut Cylinder Assembly			
Strut Piston Assembly			
Actuating Cylinder			
Strut Cylinder Assembly			
Strut Assembly Cylinder			
Outer Cylinder Assembly			
Linear Electro-Mechanical Actuator			
Axle Socket Assembly			
Refrigeration Heat Interchanger			
Linear Actuating Cylinder Assembly			
Air Heat Exchanger			
Forward Housing and Inserts Assembly			
Matrix Assembly			
Housing and Insulation			
Multiplying Lever and Bracket			
Alternating Current Motor			
Control Cam			
Drive Tube			
Fluid Filter Cover			
(FOUO) Totals	26,243,854.05	\$18,213,479.06	\$8,030,374.99

* See the Appendix for the cost analysis methodology we used to calculate the OIG Calculated Prices.

~~(FOUO)~~ Additionally, DLA may pay as much as \$11 million more than is fair and reasonable for 21 sole-source spare parts over the next 5 years if DLA's demand for sole-source spare parts continues at its current rate and no change is made. DLA should assess and implement options to recover from Ontic the \$8,030,374.99 in overpayments, in accordance with DFARS Subpart 242.71,¹⁹ and conduct a review of other sole-source spare parts purchased from Ontic and request a voluntary refund on all identified overpayments.

¹⁹ The Defense Federal Acquisition Regulation Supplement Procedures, Guidance, and Information 242.71, "Voluntary Refunds," explains that the Government may request a voluntary refund when the contracting officer concludes that the contractor overcharged under a contract. Voluntary refunds may be requested during or after contract performance.

Recommendations, Management Comments, and Our Response

Recommendation 1

We recommend the Director, Defense Logistics Agency:

- 1. Develop a quality assurance process to:**
 - a. Confirm that contracting officers' conduct and document sufficient cost and price analysis, as required, to verify that contractor prices are fair and reasonable, as required by Federal Acquisition Regulation Subpart 15.404-1, "Proposal Analysis Techniques."**

Defense Logistics Agency Comments

The Director, DLA Acquisition, responding for the Director, DLA, agreed with the recommendation. The Director stated that the contracts reviewed during the audit were awarded between May 2008 and February 2012 and that in February 2014, DLA issued guidance and included adjustments to the required checklist for the price negotiation memorandum. The Director explained that the checklist requires contracting officers to document an explanation of the price analysis, the basis or estimating technique used to determine price reasonableness, an explanation of any price analysis performed by cost element, and the submission of data other than cost or pricing data that were necessary to determine a reasonable price.

Our Response

The Director's comments addressed the specifics of the recommendation, and no further comments are required.

- b. Require contracting officers to conduct cost analysis, in addition to price analysis, on all Ontic Engineering and Manufacturing proposals to determine price reasonableness, in accordance with Federal Acquisition Regulation 15.404-1.**

Defense Logistics Agency Comments

The Director, DLA Acquisition, responding for the Director, DLA, agreed with the recommendation and stated that DLA will develop a standard operating procedure (SOP)

for contracting officers to follow when procuring sole-source items from Ontic Engineering and Manufacturing. In addition, the Director stated that the standard operating procedure will require cost analysis, in addition to price analysis, in accordance with Federal Acquisition Regulation 15.404-1. The SOP will be completed by November 30, 2014.

Our Response

The Director's comments addressed the specifics of the recommendation, and no further comments are required.

- c. **Substantiate that contracting officers verify that prime contractors with licensing agreements, such as Ontic, conduct appropriate cost or price analyses to establish the reasonableness of proposed subcontract prices and include the results of these analyses in the price proposal as required by Federal Acquisition Regulation Subpart 15.404-3, "Subcontract Pricing Considerations."**

Defense Logistics Agency Comments

The Director, DLA Acquisition, responding for the Director, DLA, agreed with the recommendation and stated that DLA will develop an SOP for contracting officers to follow when procuring items from prime contractors with licensing agreements, such as Ontic. The Director explained that the SOP will require contracting officers to conduct appropriate cost or price analyses to establish the reasonableness of proposed subcontract prices and will include the results of the analyses in the price proposal, as required by Federal Acquisition Regulation Subpart 15.404-3. The SOP will be completed by November 30, 2014.

Our Response

The Director's comments addressed the specifics of the recommendation, and no further comments are required.

Recommendation 2

Identify Ontic Engineering and Manufacturing's purchasing system as high risk and request that the administrative contracting officer review Ontic's purchasing system to determine Ontic's efficiency and effectiveness in executing DoD funding

Defense Logistics Agency Comments

The Director, DLA Acquisition, responding for the Director, DLA, agreed with the recommendation. The Director stated that DLA contacted the Administrative Contracting Officer for Ontic. The Administrative Contracting Officer requested that the Contractor Purchasing System Review Team evaluate Ontic's purchasing system and sent a Contractor Purchasing System Review Risk Assessment Form to Ontic on August 20, 2014.

Our Response

The Director's comments addressed the specifics of the recommendation, and no further comments are required.

Recommendation 3

Pursue other options for obtaining sole-source spare parts, such as determining whether they can obtain data rights sufficient for competition from original equipment manufacturers, negotiating concessions on Ontic's ongoing royalty fees, establishing an option for the direct payment of royalty fees by the Government to the original equipment manufacturers, and developing a strategy to reverse-engineer the parts or developing Government-owned technical data packages to qualify new sources and create a competitive market.

Defense Logistics Agency Comments

The Director, DLA Acquisition, responding for the Director, DLA, agreed with the recommendation and stated that DLA has been pursuing other options for obtaining sole source spare parts. For example, DLA is in discussions with Ontic regarding Ontic's practice of applying indirect costs and profit to its license fees. The Director stated that his goal is to eliminate this practice. In addition, DLA identified Ontic's sole-source parts and developed a strategy to reverse-engineer items when it is cost

effective. Specifically, the Director explained that DLA uses two reverse-engineering programs, the Replenishment Parts Purchase or Borrow Program and the Value Engineering Sourcing Support Tool. The Replenishment Parts Purchase or Borrow Program allows contractors to buy or borrow items to reverse-engineer at their own expense; DLA identified 25 Ontic parts in this program. Using the Value Engineering Sourcing Support Tool, DLA requests proposals from contractors who bid against one another to obtain the rights to reverse-engineer an item. The Government incurs the expense of reverse-engineering the parts. DLA continues to review Ontic parts to identify additional candidates for the Value Engineering Sourcing Support Tool.

Our Response

The Director's comments addressed the specifics of the recommendation, and no further comments are required.

Recommendation 4

Assess and implement available options to recover from Ontic Engineering and Manufacturing the \$8,030,374.99 in overpayments for sole-source spare parts, including voluntary refunds, in accordance with Defense Federal Acquisition Regulation Supplement Subpart 242.71, "Voluntary Refunds."

Defense Logistics Agency Comments

The Director, DLA Acquisition, responding for the Director, DLA, agreed with the recommendation and stated that DLA asked us to provide the detailed breakdown of our overpayment calculations. However, he stated that we were unable to obtain Ontic's agreement to release the contractor's proprietary data. DLA agreed to review available information to determine whether the requirements for a voluntary refund were met, in accordance with Defense Federal Acquisition Regulation Supplement Subpart 242.71. DLA will complete its review and determination by November 30, 2014.

Our Response

The Director's comments addressed the specifics of the recommendation, and no further comments are required.

Recommendation 5

Conduct a review of all sole-source spare parts purchased from Ontic Engineering and Manufacturing from October 1, 2012, to the present with a contract value greater than \$150,000, and request a voluntary refund from Ontic Engineering and Manufacturing for any identified overpayments, in accordance with Defense Federal Acquisition Regulation Supplement Subpart 242.71.

Defense Logistics Agency Comments

The Director, DLA Acquisition, responding for the Director, DLA, agreed with the recommendation and stated that DLA will review all sole-source spare parts purchased from Ontic from October 1, 2012, to the present, to identify any potential overpricing. DLA will then determine whether the requirements for a voluntary refund were met, in accordance with Defense Federal Acquisition Regulation Supplement Subpart 242.71. DLA will complete its review and determination by November 30, 2014.

Our Response

The Director's comments addressed the specifics of the recommendation, and no further comments are required.

Appendix

Scope and Methodology

We conducted this performance audit from April 2013 through July 2014 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

In June 2013, we requested information such as: cost and pricing data, proposals, purchase orders, and licensing agreements, from Ontic for 21 parts. After three months, Ontic provided the requested information. In September 2013 and January 2014, we requested additional information based on the information provided from the first request. As of July 2014, Ontic had not provided all requested information. We based our results on the information available.

Nonstatistical Audit Sample of Spare Parts

We identified 13 contracts and one basic ordering agreement with multiple delivery orders awarded to Ontic between October 1, 2007, and December 31, 2012, which exceeded the \$700,000 certified cost or pricing data threshold using the Federal Procurement Data System (FPDS). We used the Electronic Document Access (EDA) database to identify the spare parts associated with each contract as well as the delivery orders* issued against the basic ordering agreement. We nonstatistically selected for review seven parts purchased on seven contracts and eight parts purchased on eight delivery orders issued against the basic ordering agreement (N00383-08-G-005B) with the highest dollar values. In addition, we nonstatistically selected the top 6 parts purchased on 6 additional contracts from a list of 20 parts that DLA cost and pricing officials identified as potentially overpriced. We reviewed a total of 21 parts, valued at \$26.2 million. See Table A for a listing of the parts and contracts reviewed.

* A delivery order is an order for supplies that is placed against an established contract.

Table A. Summary of Contracts Reviewed

Contract Number	National Stock Number	Part Number	Part Description
W31P4Q-05-D-0006 (Delivery Order ZP01)	1440-01-197-8018	114500145-19	Linear Electro-Mechanical Actuator
SPM4A5-08-C-0102	2915-00-786-3210	710183-2	Forward Housing and Inserts Assembly
SPM4A5-09-C-0043	2915-01-180-6119	704977-3	Multiplying Lever and Bracket
SPM4A7-10-C-0746	1660-01-253-9510	78D52-3	Air Heat Exchanger
SPM4A5-11-M-G500	4330-00-238-2264	102-1531	Fluid Filter Cover
SPM4A7-11-C-0330	2935-01-203-1861	736445B	Matrix Assembly
SPRRA2-11-C-0020	6105-01-550-0504	11481714	Direct Current Motor
SPE4A4-12-V-0723	4710-00-918-9805	573322	Drive Tube
SPM4A4-12-M-0107	6105-01-130-9291	5005175A	Alternating Current Motor
SPM4A4-12-V-0042	3040-01-013-9231	752075-1	Control Cam
SPM4A7-12-C-0051	4130-01-491-1963	4101447	Refrigeration Heat Interchanger
SPRRA1-12-C-0038	1650-01-153-2314	1168960-507	Linear Actuating Cylinder Assembly
SPM4A5-13-C-0028	2915-00-728-0040	589526-1	Housing and Insulation
N00383-08-G-005B (Delivery Order 5001)	3040-01-411-5155	2581761	Actuating Cylinder
N00383-08-G-005B (Delivery Order 5004)	1620-01-407-4950	2581756	Outer Cylinder Assembly
N00383-08-G-005B (Delivery Order THA6)	1620-00-004-9856	2578145	Strut Assembly Cylinder
N00383-08-G-005B (Delivery Order THA7)	1620-00-465-2371	1706-2	Outer Cylinder Assembly
N00383-08-G-005B (Delivery Order THA8)	1620-00-461-1584	1706-112	Axle Socket Assembly
N00383-08-G-005B (Delivery Order THA9)	1620-00-461-1615	1707A2-01	Strut Cylinder Assembly
N00383-08-G-005B (Delivery Order THAA)	1620-00-465-2376	1706A104SP	Strut Piston Assembly
N00383-08-G-005B (Delivery Order THAC)	1620-00-409-6750	1707A2-02	Strut Cylinder Assembly

Interviews and Documentation

To determine whether DLA purchased sole-source spare parts from Ontic at fair and reasonable prices, we reviewed DLA's and Ontic's contract files for all 21 spare parts, dated from April 2008 through December 2012. We reviewed applicable regulations and guidance related to contract pricing and contract costs to determine whether applicable guidance was followed when establishing fair and reasonable pricing for sole-source spare parts. We reviewed FAR 2, "Definitions of Words and Terms;" FAR Subpart 15.402, "Pricing Policy;" FAR Subpart 15.403, "Obtaining Certified Cost or Pricing Data;" FAR Subpart 15.404, "Proposal Analysis;" FAR Subpart 31.2, "Contracts with Commercial Organizations;" DFARS Subpart 215.404-4, "Profit;" DFARS PGI Subpart 215.403-3(4), "Reliance on prior prices paid by the Government;" and DFARS PGI Subpart 242.71, "Voluntary Refunds."

We reviewed documentation to include requests for quotations, solicitations, contracts, modifications, orders for supplies or services, certificates of current cost or pricing data where applicable, and contract award justifications. To determine DLA's basis for awarding contracts to Ontic and the results of DLA's negotiations, we reviewed:

- records of significant events and price negotiation memorandums;
- DLA's price and cost analysis documentation to determine whether Ontic's prices were considered fair and reasonable, DLA and IHS Haystack Gold procurement histories to analyze previous purchase prices, and DCAA analysis to identify whether deficiencies in Ontic's accounting systems existed;
- Ontic's cost data to include suppliers' quotes, cost breakdowns, purchase orders, and invoices to determine how the suppliers calculated the prices they charged Ontic and how much Ontic paid its suppliers for the parts; and
- Ontic's licensing agreements with OEMs to determine the royalty percentage Ontic could charge DLA for each part.

In addition, we met with officials from Defense Procurement and Acquisition Policy and the DoD Office of General Counsel to discuss the impact of licensing agreements on spare parts pricing. We interviewed DLA contracting and pricing officials in Richmond, Virginia; DCAA auditors from the San Fernando Valley Branch Office, Van Nuys, California; and DCMA contract administration and pricing officials from the

Los Angeles Field Office, North Hill, California, to discuss cost or price analysis results, price reasonableness determinations, and price negotiations. We also interviewed personnel from Ontic in Chatsworth, California, to discuss Ontic's royalty calculations.

Price Analysis

We obtained procurement history data from DLA and the IHS Haystack Gold system to identify prior contracts for price analysis. We used EDA to obtain copies of the prior contracts and to verify the prior procurement history data provided by DLA and IHS Haystack Gold. For comparison purposes, we selected the most recent, previous contract awarded for new manufactured parts, and purchased from a supplier other than Ontic, when available. We escalated the prior contract prices to the same month and year of the contracts selected for review based on escalation factors from the Bureau of Labor Statistics Producer Price Indexes. We either used the same Producer Price Index that DLA used in its price analysis when an index was specified or we used the Producer Price Index for "other aircraft parts and equipment" when an index was not specified. We compared the escalated previous purchase prices to contract unit prices to determine whether there were significant price increases.

Cost Analysis

For each of the 21 sample parts selected for review, we requested that Ontic provide supporting documentation for contract prices. We obtained from Ontic and reviewed Ontic's Government cost estimates, purchase orders, labor-hour summaries, royalty calculation, and actual annual cost summaries. We interviewed Ontic officials to determine Ontic's business processes, pricing practices, cost-estimating methodology, and value-added services. We also requested DCAA analysis of Ontic's proposals and DCMA technical reviews, which we reviewed to help us identify questionable and unsupported costs.

We analyzed Ontic's Government cost estimates and supporting documentation to identify costs that were unallowable because the costs were either unallocable or unreasonable to the Government. We developed an OIG calculated price using Ontic's cost-estimating methodology, which we modified to remove the costs determined unallowable and revised to incorporate Ontic's actual cost data. We then compared our OIG calculated prices with DLA's contracted prices for the 21 parts selected for review to determine the amount DLA paid over a fair and reasonable price.

Use of Computer-Processed Data

We assessed the reliability of DLA's procurement histories, IHS Haystack Gold data, EDA, and FPDS by comparing contract data with source documents. Specifically, we used DLA's procurement histories and IHS Haystack Gold data to identify prior contracts to compare with Ontic's prices. In addition, we used DLA's procurement histories to calculate DLA's procurement quantities for the 21 parts for FY's 2009 through 2013. We used EDA to obtain electronic copies of contracts, delivery orders, and modifications for the prior contracts and for Ontic contracts reviewed. We compared DLA procurement histories, IHS Haystack Gold data, and FPDS data with the contracts, delivery orders, and modifications. As a result, we determined that the data were sufficiently reliable for the purposes of this report.

Use of Technical Assistance

We consulted with the DoD OIG Quantitative Methods Division while determining our nonstatistical audit sample.

Prior Coverage

During the last five years, the DoD OIG issued seven final reports related to DoD obtaining parts at fair and reasonable prices. Unrestricted DoD OIG reports can be accessed at <http://www.dodig.mil/audit/reports>.

DOD IG

Report No. DODIG-2014-088, "Defense Logistics Agency Aviation Potentially Overpaid Bell Helicopter for Sole-Source Commercial Spare Parts," July 3, 2014

Report No. DODIG-2014-054, "Defense Logistics Agency Land and Maritime Paid Too Much for High Mobility Multipurpose Wheeled Vehicle Repair Parts," April 4, 2014

Report No. DODIG-2014-038, "Air Force Life Cycle Management Center Could Not Identify Actual Cost of F119 Engine Spare Parts Purchased from Pratt and Whitney," February 10, 2014

Report No. DODIG-2014-020, "U.S. Army Contracting Command Did Not Obtain Fair and Reasonable Prices for Communications Equipment," December 5, 2013

Report No. D-2013-090, "Improved Guidance Needed to Obtain Fair and Reasonable Prices for Sole-Source Spare Parts Procured by the Defense Logistics Agency From The Boeing Company," June 7, 2013

Report No. D-2011-104, "Pricing and Escalation Issues Weaken the Effectiveness of the Army Contract with Sikorsky to Support the Corpus Christi Army Depot," September 8, 2011

Report No. D-2011-061, "Excess Inventory and Contract Pricing Problems Jeopardize the Army Contract with Boeing to Support the Corpus Christi Army Depot," May 3, 2011

Management Comments

Defense Logistics Agency



DEFENSE LOGISTICS AGENCY
HEADQUARTERS
8725 JOHN J. KINGMAN ROAD
FORT BELVOIR, VIRGINIA 22060-6221

AUG 25 2014

MEMORANDUM FOR THE DEPARTMENT OF DEFENSE INSPECTOR GENERAL

SUBJECT: Response to DoD IG Draft Report "Onsite Engineering and Manufacturing
Overcharged the Defense Logistics Agency for Sole-Source Spare Parts," (Project
No. D2013-D000CH-0153.00)

Attached is the Defense Logistics Agency's (DLA) response to the subject Draft Report.
We appreciate the opportunity to review and comment on the finding and recommendations.

The point of contact for this audit is [REDACTED] DLA Office of the Inspector
General, [REDACTED]

A handwritten signature in black ink, appearing to read "Matthew R. Beebe".

MATTHEW R. BEEBE
Director, DLA Acquisition

Attachment:
As stated

Defense Logistics Agency (cont'd)

Recommendation 1a: We recommend the Director, Defense Logistics Agency (DLA) develop a quality assurance process to confirm that contracting officers' conduct and document sufficient cost and price analysis, as required, to verify that contractor prices are fair and reasonable, as required by Federal Acquisition Regulation Subpart 15.404-1, "Proposal Analysis Techniques."

DLA Response: Concur. The contracts reviewed in this audit were awarded between May 2008 and February 2012. Since that time, DLA instituted a number of process improvements in line with the intent of this recommendation. Standard Procurement Letter (PROCLTR) 2014-61 was issued in February 2014 and included adjustments to the required Price Negotiation Memorandum (PNM) checklist. Checklist section 5, Negotiation Summary, requires the Contracting Officer document an explanation of the price analysis performed, the basis or estimating technique used to determine price reasonableness, an explanation of any price analysis performed by cost element, and the submission of data other than cost or pricing data necessary to determine a reasonable price.

Recommendation 1b: We recommend the Director, Defense Logistics Agency (DLA) develop a quality assurance process to require contracting officers to conduct cost analysis, in addition to price analysis, on all Ontic Engineering and Manufacturing proposals to determine price reasonableness, in accordance with Federal Acquisition Regulation 15.404-1.

DLA Response: Concur. DLA will develop a Standard Operating Procedure (SOP) for contracting officers to follow when procuring all Ontic Engineering and Manufacturing sole source items. The SOP will include the requirement to conduct cost analysis, in addition to price analysis in accordance with Federal Acquisition Regulation 15.404-1. The SOP will be completed by November 30, 2014.

Recommendation 1c: We recommend the Director, Defense Logistics Agency (DLA) develop a quality assurance process to substantiate that contracting officers verify that prime contractors with licensing agreements, such as Ontic, conduct appropriate cost or price analyses to establish the reasonableness of proposed subcontract prices and include the results of these analyses in the price proposal as required by Federal Acquisition Regulation Subpart 15.404-3, "Subcontract Pricing Considerations."

DLA Response: Concur. DLA will develop a Standard Operating Procedure (SOP) for contracting officers to follow when procuring items from prime contractors with licensing agreements, such as Ontic. The SOP will include the requirement for contracting officers to conduct appropriate cost or price analyses to establish the reasonableness of proposed subcontract prices and include the results of these analyses in the price proposal as required by Federal Acquisition Regulation Subpart 15.404-3, "Subcontract Pricing Considerations." The SOP will be completed by November 30, 2014.

Recommendation 2: Identify Ontic Engineering and Manufacturing's purchasing system as high risk and request that the administrative contracting officer review Ontic's purchasing system to determine Ontic's efficiency and effectiveness in executing DoD funding.

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DLA Response: Concur. DLA contacted the Administrative Contracting Officer (ACO) for Ontic Engineering and Manufacturing. The ACO requested the Contractor Purchasing System Review (CPSR) Team evaluate Ontic's purchasing system. Additionally, the ACO sent a CPSR Risk Assessment Form to Ontic on August 20, 2014.

Recommendation 3: Pursue other options for obtaining sole-source spare parts, such as determining whether they can obtain data rights sufficient for competition from original equipment manufacturers, negotiating concessions on Ontic's ongoing royalty fees, establishing an option for the direct payment of royalty fees by the Government to the original equipment manufacturers, and developing a strategy to reverse-engineer the parts or developing Government-owned technical data packages to qualify new sources and create a competitive market.

DLA Response: Concur. DLA is currently pursuing various options for obtaining sole source spare parts. DLA is in preliminary discussions with Original Equipment Manufacturers (OEMs) who have licensing agreements with Ontic. These discussions include the option of either 1) obtaining the data; or 2) obtaining the right to use the data.

DLA is also in discussions with Ontic regarding their current practice of burdening the licensing fees with indirect costs and profit in their proposals. These discussions are aimed at eliminating the practice.

DLA identified the sole source parts provided by Ontic and developed a strategy to reverse engineer items when it is cost effective. DLA utilizes two reverse engineering programs. The first is the Replenishment Parts Purchase or Borrow Program (RPPOB). This program allows contractors to buy or borrow part numbered items to reverse engineer at their own expense. Currently, DLA has 25 NSNs that are coded to Ontic on the RPPOB website. The second program uses the Value Engineering Sourcing Support Tool (VESST). Under this program, DLA requests proposals from contractors who bid against one another for the rights to reverse engineer an item. The cost to reverse engineer is done at the government expense. DLA has invested over \$250,000 in breaking out eight specific high value items. DLA continues to review Ontic items to identify additional candidates to solicit under VESST.

Recommendation 4: Assess and implement available options to recover from Ontic Engineering and Manufacturing the \$8,078,858.73 in overpayments for sole-source spare parts, including voluntary refunds, in accordance with Defense Federal Acquisition Regulation Supplement Subpart 242.71, "Voluntary Refunds."

DLA Response: Concur. DLA requested the DoD IG provide the detailed breakdown of their calculation of the \$8,078,858.73. However, they were unable to obtain Ontic's agreement to release the company's proprietary data. Therefore, DLA will review the information currently available to determine if the requirements for a voluntary refund are met in accordance with DFARS Subpart 242.71. The review and determination will be complete by November 30, 2014.

Recommendation 5: Conduct a review of all sole-source spare parts purchased from Ontic Engineering and Manufacturing from October 1, 2012, to the present with a contract value

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greater than \$150,000, and request a voluntary refund from Ontic Engineering and Manufacturing for any identified overpayments, in accordance with Defense Federal Acquisition Regulation Supplement (DFARS) Subpart 242.71.

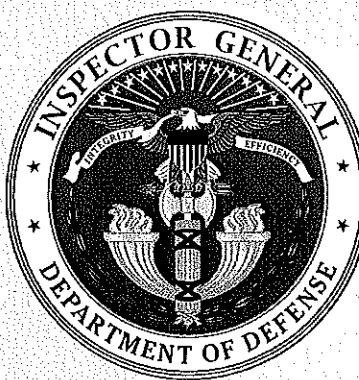
DLA Response: Concur. DLA will review all sole-source spare parts purchased from Ontic from October 1, 2012 to the present to identify any potential overpricing. Upon completion, a determination will be made if the requirements for a voluntary refund are met in accordance with DFARS Subpart 24.271. The review and determination will be completed by November 30, 2014.

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Acronyms and Abbreviations

CPSR Contractor's Purchasing System Review
DCAA Defense Contract Audit Agency
DCMA Defense Contract Management Agency
DFARS Defense Federal Acquisition Regulation Supplement
DLA Defense Logistics Agency
EDA Electronic Document Access
FAR Federal Acquisition Regulation
FPDS Federal Procurement Data System
G&A General and Administrative
OEM Original Equipment Manufacturer
SOP Standard Operating Procedure

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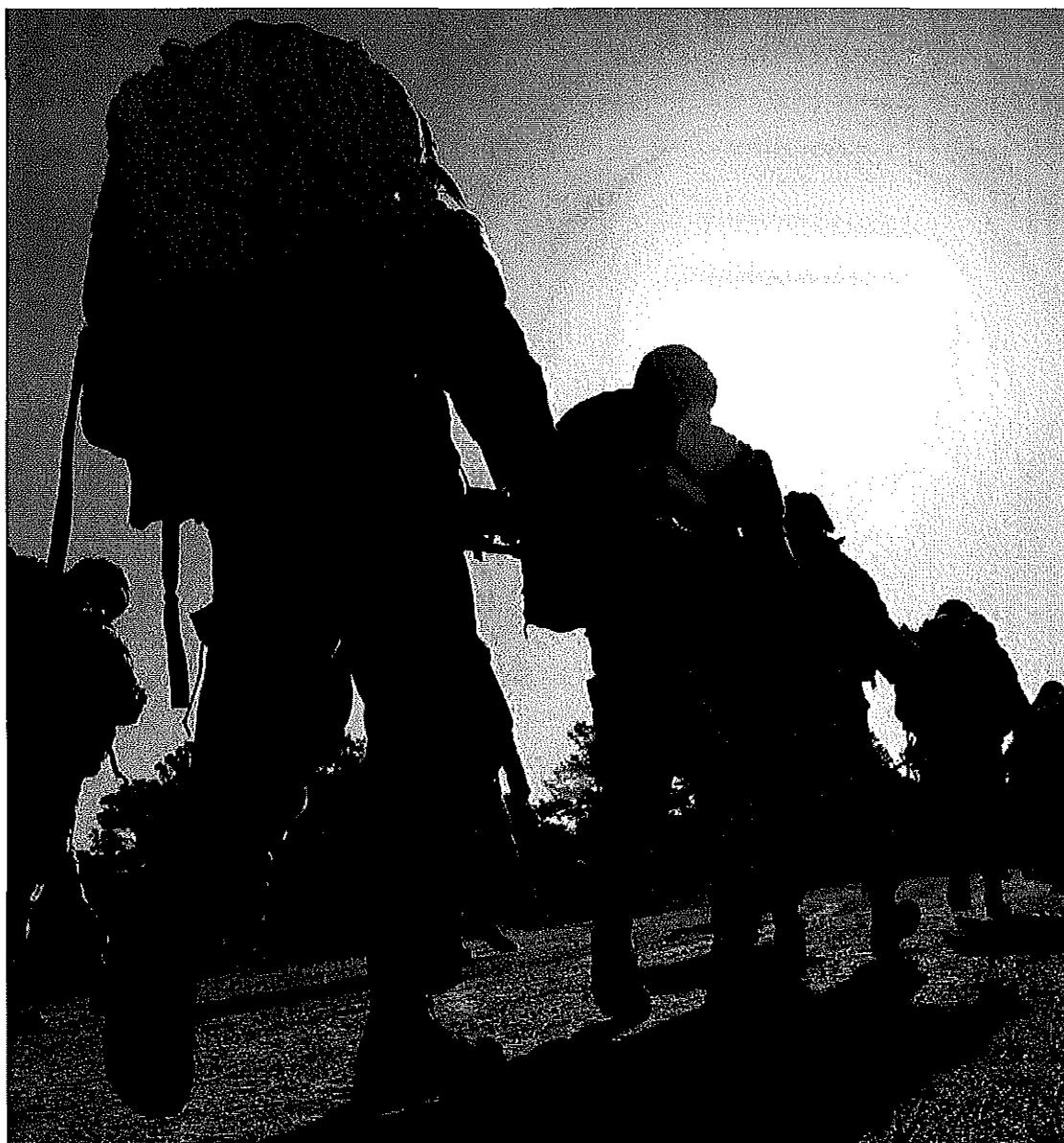
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